Docket 01-0423
ICC Staff Exhibit 5.0CR

REDACTED DIRECT TESTIMONY

OF

JANIS FREETLY

FINANCIAL ANALYST

FINANCE DEPARTMENT

FINANCIAL ANALYSIS DIVISION

ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY

Petition for Approval of Delivery Services Tariffs and Tariff Revisions and Residential Delivery Services Implementation Plan, and for Approval of Certain Other Amendments and Additions to its Rates, Terms, and Conditions

DOCKET NO. 01-0423

August 23, 2001

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Witness Identification

Q. Please state your name and business address.

A. My name is Janis Freetly. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

Q. What is your current position with the Illinois Commerce Commission ("Commission")?

A. I am currently employed as a Financial Analyst in the Finance Department of the Financial Analysis Division.

Q. Please describe your qualifications and background.

A. In May of 1995, I earned a Bachelor of Business degree in Marketing from Western Illinois University. I received a Master of Business Administration degree, with a concentration in Finance, from Western Illinois University in May of 1998. I have been employed by the Commission since September of 1998.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony and accompanying schedules is to present my analysis of the cost of capital of, and recommend an overall rate of return for, the

electric delivery service operations of Commonwealth Edison Company ("ComEd").

Cost of Capital

Q. Please summarize your cost of capital findings.

A. The overall cost of capital for ComEd is 8.74%, as shown on Schedule 5.1.

Q. Why is it important to determine a reasonable cost of capital for a public utility?

A. A primary objective of regulation is to minimize the cost of reliable service to ratepayers while allowing public utilities to earn a fair and reasonable rate of return. When a public utility is authorized a rate of return equal to a reasonable cost of capital, the interests of ratepayers and investors are properly balanced. If the authorized rate of return is greater than a reasonable cost of capital, ratepayers are burdened with excessive rates. Conversely, if the authorized rate of return is less than a reasonable cost of capital, the utility may be unable to raise capital at a reasonable cost and ultimately may be unable to raise sufficient capital to meet demands for service. Therefore, the interests of ratepayers and investors are best served when a utility's allowed rate of return is set equal to a reasonable overall cost of capital.

Q. What is the overall cost of capital for a public utility?

A. The overall cost of capital is the sum of the component costs of the capital structure (i.e., debt, preferred stock, and common equity) after each is weighted by its proportion to total capital. It represents the rate of return the public utility needs to earn on its assets to satisfy contractual obligations to, or the market requirements of, its investors.

Capital Structure

Q. Does capital structure affect the overall cost of capital?

A. Yes. Financial theory suggests capital structure will affect the value of a firm and, therefore, its cost of capital, to the extent it affects the expected level of cash flows that accrue to third parties (i.e., other than debt and stock holders). Employing debt as a source of capital reduces a company's income taxes,[1] thereby reducing the cost of capital. However, as reliance on debt as a source of capital increases, so does the probability of bankruptcy. As bankruptcy becomes more probable, expected payments to attorneys, trustees, accountants and other third parties increase. Simultaneously, the expected value of the income tax shield provided by debt financing declines. Beyond a certain point, a growing dependence on debt

[1] The tax advantage debt has over equity at the corporate level is partially offset at the individual investor level. Debt investors receive returns largely in the form of current income (i.e., interest). In contrast, equity investors receive returns in the form of both current income (i.e., dividends) and capital appreciation (i.e., capital gains). Taxes on capital gains are lower than taxes on interest and dividend income because capital gains tax rates are lower, and taxes on capital gains are deferred until realized.

as a source of funds increases the overall cost of capital. Therefore, the Commission should not determine the overall rate of return from a utility's actual capital structure if it determines that capital structure adversely affects the overall cost of capital.

An optimal capital structure would minimize the cost associated with the capital a utility raises and maintain its financial integrity. Unfortunately, determining whether a capital structure is optimal remains problematic because (1) the cost of capital is a continuous function of the capital structure, rendering its precise measurement along each segment of the range of possible capital structures problematic; (2) the optimal capital structure is a function of operating risk, which is dynamic; and (3) the relative costs of the different types of capital vary with dynamic market conditions. Consequently, one should determine whether the capital structure is consistent with the financial strength necessary to access the capital markets under all conditions, and if so, whether the cost of that financial strength is reasonable.

Q. What capital structure did ComEd propose for setting rates?

A. ComEd proposed using a pro-forma December 31, 2000 capital structure that contains 53.99% long-term debt and 46.01% common equity, as shown on Schedule 5.1.[2]

Q. What capital structure do you recommend?

A. I recommend the Commission adopt ComEd's March 31, 2001 capital structure consisting of roughly 61% debt and 39% equity, as shown on Schedule 5.1.

Q. Why should the Commission not adopt the capital structure proposed by ComEd?

A. The Commission should not adopt the pro-forma December 31, 2000 capital structure proposed by ComEd because it is adjusted inconsistently. No pro-forma adjustments were made to the balance of regular long-term debt. However, ComEd adjusted the balance of long-term debt to reflect forecasted retirements of transitional funding instruments from 2001 through 2002. The balance of common equity was adjusted to account for ComEd's corporate restructuring in January, 2001. Therefore, ComEd made inconsistent pro-forma adjustments with respect to time. The different components of the capital structure should reflect adjustments over consistent time periods.

[2] ComEd Schedule 11.1, page 1 of 3.

Q. Why is consistency in capital structure adjustments important?

A. Consistency in capital structure adjustments is necessary to accurately measure the amount and proportions of capital in use as of a certain point in time. Each retirement of capital, scheduled or otherwise, requires funds from either asset liquidations or new capital such as debt, preferred stock, or common equity. Consequently, ComEd's pro forma capital structure understates the amount of capital in use as of December 2000 and December 2002. ComEd's pro-forma adjustments imply that it will generate enough funds internally to cover the retirement of these transitional funding obligations.[3] However, without forecasted financial statements, that implication cannot be verified.

Q. Did you request forecasted financial statements for the years 2001 and 2002?

A. Yes. However, ComEd objected to that request and failed to provide those forecasted financial statements. I have provided ComEd's response to that data request as Attachment A.

Q. Should short-term debt be included in the capital structure of ComEd?

A. No. Short-term debt is not a permanent source of financing rate base investments by ComEd.

Q. Should preferred stock be included in the capital structure of ComEd?

A. No. ComEd reported a zero balance of preferred securities outstanding as of March 31, 2001.

Q. How did you determine the balance of long-term debt?

A. The balance of long-term debt should reflect the carrying value of all of the outstanding debt issues, including the Transitional Funding Obligations. I began with the face amount outstanding balances as reported in ComEd's FERC Form 1 Annual Report for the year ended December 31, 2000. From those balances, I subtracted the March 31, 2001 balances of unamortized debt discount or premium and the unamortized debt expense. I also accounted for the unamortized loss and gain on reacquired debt for those issues that have been retired. As shown on Schedule 5.2, the resulting carrying value of long-term debt equals $7,629,187,696.

Q. How did you determine the March 31, 2001 balances of unamortized discount and premium and the unamortized debt expense?

A. I began with the balances listed in ComEd's FERC Form 1 Annual Report for the year ended December 31, 2000. Since the balances listed in the FERC report are as of the date of issuance, I subtracted the amortization from the issuance

[3] Response of ComEd to Staff Data Request JF-2.08.

date through March 31, 2001. I computed the amortization on a straight-line basis over the lives of the respective issues, in accordance with the methodology followed by ComEd.[4]

Q. Why didn't you use the unamortized debt discount and premium balances reported by ComEd on Schedule WPFIN-3.1?

A. ComEd adjusted the unamortized discount and premium balances to reflect the difference between the estimated fair market value and the carrying value of each long-term debt issue.[5] ComEd made such adjustments to reflect the purchase method of accounting used to account for the merger of PECO and Unicom. However, since rates are set on the basis of original cost for ComEd, original, actual costs should be used to calculate the balance and embedded cost of debt. Further, restating carrying value[6] to fair market value produces illogical debt costs. Debt issues bearing embedded interest rates below current market interest rates are reduced in carrying value. Conversely, debt issues bearing embedded interest rates above current market interest rates are increased in carrying value. Since the cost of debt equals total interest expense divided by carrying value, decreases in the carrying value of debt issues bearing below market interest costs would increase the cost of debt while increases in the carrying value of debt issues bearing above market interest costs would decrease the cost of debt. This would

[4] Response of ComEd to Staff Data Request JF-1.06.
[5] Response of ComEd to Staff Data Request JF-1.03.

result in ratepayers overcompensating ComEd for its below market cost debt and under compensating ComEd for its above market cost debt. Therefore, I used the actual discount or premium balance as of the issuance date as the starting point for determining the unamortized balance of discount or premium as of March 31, 2001.

Q. How did you determine the balance of common equity?

A. To determine the balance of common equity, I began with the total shareholders equity balance listed in the 10Q Quarterly Report for the quarter ended March 31, 2001. I subtracted the preferred stock of a subsidiary from that balance to arrive at the balance shown on Schedule 5.1.

Q. Is your recommended capital structure reasonable for determining ComEd's overall rate of return?

A. Yes. I compared my March 31, 2001 proposed capital structure for ComEd to industry standards. For the four quarters ending with the first quarter of 2001, the weighted average common equity ratio for the electric utilities in *Standard & Poor's Utility Compustat* equaled 34.01%, with a standard deviation of 9.49%. For the four quarters ending with the first quarter of 2001, the weighted average common equity ratio for the gas distribution companies in *Standard & Poor's*

[6] The carrying value represents the proceeds available to the Company from the issuance of debt after accounting for any discounts or premiums and expenses.

Utility Compustat equaled 42.05%, with a standard deviation of 6.70%. The 39.36% common equity ratio that I am proposing for ComEd is within one standard deviation of the average of both industries and between their average equity ratios; therefore, it can be considered reasonable.

Standard & Poor's ("S&P") categorizes debt securities on the basis of the risk that a company will default on its interest or principal payment obligations. The resulting credit rating reflects both the operating and financial risks of a utility.[7] Although no formula exists for determining a credit rating, S&P publishes mean and median values of various financial ratios by credit rating. Electric utilities with an A credit rating have a mean total debt ratio of 50.64% and a mean common equity of 44.82%.[8] Gas distribution utilities with an A credit rating have a mean total debt ratio of 48.80% and a mean common equity ratio of 50.30%.[9] Given that 35% of ComEd's debt is composed of relatively low cost Transitional Funding Notes ("TFNs"), the proximity of ComEd's capital structure to those industry standards indicates that the former is reasonable for the purpose of setting rates.

Cost of Long-Term Debt

Q. What is the embedded cost of long-term debt for ComEd?

[7] *Standard & Poor's Utility Financial Statistics*, June 1999, p. 3; *Standard & Poor's Utilities Rating Service: Industry Commentary*, May 20, 1996, p. 1.
[8] *Standard & Poor's Financial Medians Electric Utilities*, www.ratingsdirect.com, July 7, 2000.
[9] *Standard & Poor's Financial Medians Gas Distribution*, www.ratingsdirect.com, July 7, 2000.

A. As of March 31, 2001, the embedded cost of long-term debt was 6.82%, as shown on Schedule 5.2.

Q. Please describe the adjustments you made to ComEd's debt schedule.

A. As mentioned previously, I computed the unamortized discount or premium and the unamortized debt expense based on the balances at issue reported in the FERC Form 1 annual report for the year ended December 31, 2000. The annual amortization of debt discount or premium and expense was adjusted to reflect straight-line amortization of their respective unamortized balances over the life of each issue. I also itemized the annual amortization of the unamortized debt expense associated with reacquired issues.

I included the annual publishing expense fees in the annual amortization of debt expense. However, I did not include the fees in unamortized debt expense. These are costs of redeeming sinking fund debentures that ComEd amortizes over twelve months.[10] Given that ComEd proposed to recover these costs in one year, recovery of a return on an unamortized balance is inappropriate since there is no unamortized balance remaining following twelve months amortization.

I updated the interest rates on the variable rate debt to reflect current interest rates. For the Illinois Development Finance Authority Series 1994B and 1994C, I used the current 2.57% rate on "Aaa" rated, one-year municipal debt published by the

[10] ComEd Response to Staff Data Request JF-4.01.

Municipal Market Advisors.[11] For the variable rate Senior notes, I used the current 3.59% LIBOR rate[12], plus 0.50% for the Senior notes due 2002 and plus 0.625% for the Senior notes due 2003.[13]

Cost of Common Equity

Q. What is ComEd's cost of common equity?

A. My analysis indicates that the cost of common equity for ComEd's delivery service operations is 11.71%.

Q. How did you measure the investor-required rate of return on common equity for ComEd?

A. I measured the investor-required rate of return on common equity for ComEd with the discounted cash flow ("DCF") and risk premium models. Since ComEd does not have market-traded common stock, DCF and risk premium models cannot be applied directly to ComEd, therefore, I applied both models to a sample of integrated electric utility companies and a sample of gas distribution companies. ComEd witness Daniel E. Thone included a sample of gas utilities due to their primary function as a delivery services provider, and the gas industry has already

[11] Municipal Market Advisors - Municipal Consensus 'Aaa' General Obligation Yield Analysis, August 17, 2001, http://www.bondresources.com/Municipal/Rates.
[12] *The Wall Street Journal*, August 13, 2001.
[13] Supplemental Response of ComEd to Staff Data Request FIN-3.

moved toward deregulation.[14] I also included a gas sample, however, gas utilities may be exposed to commodity risks that electric distribution companies do not face.

Sample Selection

Q. How did you select an electric sample?

A. Since this proceeding will set rates for electric delivery services, under ideal circumstances the sample should reflect the risks associated with the provision of those services. Unfortunately, few, if any, market-traded electric utilities in the United States provide only electric delivery services. Therefore, I selected an electric sample based on the following criteria. First, I began with a list of all domestic publicly traded companies assigned an industry number of 4911 or 4931 (i.e., electric utilities) within *S&P Utility Compustat*. Second, I removed any company which derived less than 75% of its revenue from electric services, based on 2000 data. Third, I removed any company that had an S&P debt rating other than A, A-, or BBB+. Fourth, I removed any company which had neither Zacks Investment Research ("Zacks") nor Institutional Brokers Estimate System ("IBES") long-term growth rates. Fifth, I removed companies involved in pending significant mergers or acquisitions. Sixth, I removed companies without Value Line beta estimates. The remaining companies, American Electric Power; CLECO Corp.;

[14] ComEd Exhibit 8.0, Direct Testimony of Daniel E. Thone, p. 7.

DPL Inc.; DQE Inc.; Kansas City Power & Light; NSTAR; and Puget Energy Inc., compose my Electric sample.

Q. How did you select a gas sample?

A. First, I began with a list of all domestic publicly traded companies assigned an industry number of 4924 within *S&P Utility Compustat*. Second, I removed any company which derived less than 75% of its revenue from gas services, based on 2000 data. Third, I removed any company that had an S&P debt rating outside the range of A+ through BBB. Fourth, I removed any company which had neither Zacks nor IBES long-term growth rates. Fifth, I removed companies involved in pending significant mergers or acquisitions. Finally, I removed Southern Union because it does not pay dividends. The remaining companies, AGL Resources Inc.; Atmos Energy Corp.; Cascade Natural Gas Corp.; NUI Corp.; Northwest Natural Gas Co; Peoples Energy Corp.; Piedmont Natural Gas Co.; and South Jersey Industries, compose my Gas sample.

Q. Please discuss the criteria by which you selected your samples.

A. The percentage of revenues from electric or gas sales is an operating risk measure. The S&P credit ratings measure the risk that a company will default on financial obligations, which is a function of both operating and financial risk.[15] By

[15] Standard & Poor's, *Utilities Rating Service: Financial Statistics, Twelve Months Ended June 30, 1998*, p. 1; Standard & Poor's, *Utilities Rating Service: Industry Commentary*, May 20, 1996, p. 1.

limiting the sample to companies with a high percentage of revenue from electric or gas sales and S&P credit ratings similar to that of ComEd, the sample should approach the risk of the electric delivery services operations of ComEd. In addition, removing companies that have pending significant mergers ensures that merger premiums do not distort the results of my analysis.

Q. In past rate cases Staff has utilized a general utility sample selected on the basis of a quantitative comparison in risk to the utility. Did you include such a sample in your analysis?

A. No. A quantitative analysis of risk using Staff's comparable sample methodology is not practicable for two reasons. First, recent industry restructuring has rendered questionable the measurement of financial and operating risk with historical data for many electric utilities. Second, although ComEd has restructured as a transmission and distribution company, it has only operated on that basis since January 2001, while the comparable sample database does not yet include 2001 data. Thus, the available data would reflect integrated electric operations for ComEd rather than the delivery services portion for which rates are being set.

DCF Analysis

Q. Please describe DCF analysis.

A. For a utility to attract common equity capital, it must provide a rate of return on common equity sufficient to meet investor requirements. DCF analysis establishes a rate of return directly from investor requirements. A comprehensive analysis of a utility's operating and financial risks becomes unnecessary to implement a DCF analysis since the market price of a utility's stock already embodies the market consensus of those risks.

According to DCF theory, a security price equals the present value of the cash flow investors expect it to generate. Specifically, the market value of common stock equals the cumulative value of the expected stream of future dividends after each is discounted by the investor-required rate of return.

Q. Please describe the DCF model with which you measured the investor-required rate of return on common equity.

A. As it applies to common stocks, DCF analysis is generally employed to determine appropriate stock prices given a specified discount rate. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that stock prices embody. As such, incorporating stock prices that the financial market sets on the basis of quarterly dividend payments into a model that ignores the time value of quarterly cash flows constitutes a misapplication of DCF analysis.

The companies in both samples pay dividends quarterly; therefore, I applied a constant-growth DCF model that measures the annual required rate of return on common equity as follows:

$$k = \frac{\sum_{q=1}^{4} D_{0,q}(1+g)(1+k)^{1-[x+0.25(q-1)]}}{P} + g.$$

where P ≡ the current stock price;

$D_{0,q}$ ≡ the last dividend paid at the end of quarter q, where q = 1 to 4;

k ≡ the cost of common equity;

x ≡ the elapsed time between the stock observation and first dividend payment dates, in years; and

g ≡ the expected dividend growth rate.

That model assumes dividends will grow at a constant rate, and the market value of common stock (i.e., stock price) equals the sum of the discounted value of each dividend.

Q. How did you estimate the growth rate parameter?

A. Determining the market-required rate of return with the DCF methodology requires a growth rate that reflects the expectations of investors. Although the current market price reflects aggregate investor expectations, market-consensus expected growth rates cannot be measured directly. Therefore, I measured market-consensus expected growth indirectly with growth rates forecasted by securities analysts that are disseminated to investors.

IBES and Zacks summarize and publish the earnings growth expectations of financial analysts that the research departments of investment brokerage firms employ. To measure market-consensus expected growth, I averaged the IBES and Zacks growth rate estimates. Schedule 5.3 presents the analyst growth rate estimates for the companies in the samples.

Q. Why did you not use July estimates growth rates?

A. At the time of my analysis, IBES growth rates as of June 14, 2001, were the most recently available. I have not yet received the July IBES report. When the data becomes available, I will update my analysis to reflect the more recent growth rate estimates.

Q. How did you measure the stock price?

A. A current stock price reflects all information that is available and relevant to the market; thus, it represents the market's assessment of the common stock's current value. I measured each company's current stock price with its closing market price from August 10, 2001. Those stock prices appear on Schedule 5.4.

Since current stock prices reflect the market's current expectation of the cash flows the securities will produce and the rate at which those cash flows are discounted, an observed change in the market price does not necessarily indicate a change in the required rate of return on common equity. Rather, a price change may reflect

investors' re-evaluation of the expected dividend growth rate. In addition, stock prices change with the approach of dividend payment dates. Consequently, when estimating the required return on common equity with the DCF model, one should measure the expected dividend yield and the corresponding expected growth rate concurrently. Using an historical stock price along with current growth expectations or combining an updated stock price with past growth expectations would likely produce an inaccurate estimate of the market-required rate of return on common equity.

Q. Please explain the significance of the column titled "Next Dividend Payment Date" shown on Schedule 5.4.

A. Estimating year-end dividend values requires measuring the length of time between each dividend payment date and the first anniversary of the stock observation date. For the first dividend payment, that length of time is measured from the "Next Dividend Payment Date." Subsequent dividend payments occur in quarterly intervals.

Q. How did you estimate the next four expected quarterly dividends?

A. Most utilities declare and pay the same dividend per share for four consecutive quarters before adjusting the rate. Consequently, I assumed the dividend rate will adjust during the same quarter it changed during the preceding year. If the utility

did not change its dividend during the last year, I assumed the rate would change during the next quarter. The average expected growth rate was applied to the current dividend rate to estimate the expected dividend rate. Schedule 5.4 presents the current quarterly dividends. Schedule 5.5 presents the expected quarterly dividends.

Q. Based on your DCF analysis, what are the estimated required rates of return on common equity for the electric sample and the gas sample?

A. The DCF analysis estimated required rates of return on common equity estimates of 13.37% for the Electric sample and 11.90% for the Gas sample, as shown on Schedule 5.6. Those results represent averages of the DCF estimates for the individual companies in each sample, which are derived from the growth rates presented on Schedule 5.3, the stock price and dividend payment dates presented on Schedule 5.4, and the expected quarterly dividends presented on Schedule 5.5.

Risk Premium Analysis

Q. Please describe the risk premium model.

A. The risk premium model is based on the theory that the market-required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. A risk premium represents the additional return

investors expect in exchange for assuming the risk inherent in an investment. Mathematically, a risk premium equals the difference between the expected rate of return on a risk factor and the risk-free rate. If the risk of a security is measured relative to a portfolio, then multiplying that relative measure of risk and the portfolio's risk premium produces a security-specific risk premium for that risk factor.

The risk premium methodology is consistent with the theory that investors are risk-averse. That is, investors require higher returns to accept greater exposure to risk. Thus, if investors had an opportunity to purchase one of two securities with equal expected returns, they would purchase the security with less risk. Conversely, if investors had an opportunity to purchase one of two securities with equal risk, they would purchase the security with the higher expected return. In equilibrium, two securities with equal quantities of risk have equal required rates of return.

The Capital Asset Pricing Model ("CAPM") is a one-factor risk premium model that mathematically depicts the relationship between risk and return as:

$$R_j = R_f + \beta_j \times (R_m - R_f)$$

where R_j ≡ the required rate of return for security j;

R_f ≡ the risk-free rate;

R_m ≡ the expected rate of return for the market portfolio; and

β_j ≡ the measure of market risk for security j.

In the CAPM, the risk factor is market risk which is defined as risk that cannot be eliminated through portfolio diversification. To implement the CAPM, one must estimate the risk-free rate of return, the expected rate of return on the market portfolio, and a security or portfolio-specific measure of market risk.

Q. How did you estimate the risk-free rate of return?

A. I examined the suitability of the yields on three-month U.S. Treasury bills and thirty-year U.S. Treasury bonds as estimates of the risk-free rate of return.

Q. Why did you examine the yields on U.S. Treasury bills and bonds as measures of the risk-free rate?

A. The proxy for the nominal risk-free rate should contain no risk premium and reflect similar inflation and real risk-free rate expectations to the security being analyzed through the risk premium methodology.[16] The yields of fixed income securities include premiums for default and interest rate risk. Default risk pertains to the possibility of default on principal or interest payments. Securities of the United States Treasury are virtually free of default risk by virtue of the federal government's fiscal and monetary authority. Interest rate risk pertains to the effect of unexpected interest rate fluctuations on the value of securities.

[16] Real risk-free rate and inflation expectations comprise the non-risk portion of a security's rate of return.

Since common equity theoretically has an infinite life, its market-required rate of return reflects the inflation and real risk-free rates anticipated to prevail over the long run. U.S. Treasury bonds, the longest term treasury securities, are issued with terms to maturity of thirty years; U.S. Treasury notes are issued with terms to maturity ranging from two to ten years; U.S. Treasury bills are issued with terms to maturity ranging from ninety-one days to one year. Therefore, U.S. Treasury bonds are more likely to incorporate within their yields the inflation and real risk-free rate expectations that drive, in part, the prices of common stocks than either U.S. Treasury notes or Treasury bills.

However, due to relatively long terms to maturity, U.S. Treasury bond yields also contain an interest rate risk premium that diminishes their usefulness as measures of the risk-free rate. U.S. Treasury bill yields contain a smaller premium for interest rate risk. Thus, in terms of interest rate risk, U.S. Treasury bill yields more accurately measure the risk-free rate.

Q. Given that the inflation and real risk-free rate expectations reflected in the yields on U.S. Treasury bonds and the prices of common stocks are similar, does it necessarily follow that the inflation and real risk-free rate expectations that are reflected in the yields on U.S. Treasury bills and the prices of common stocks are dissimilar?

A. No. To the contrary, short and long-term inflation and real risk-free rate expectations, including those that are reflected in the yields on U.S. Treasury bills, U.S. Treasury bonds, and the prices of common stocks, should equal over time. Any other assumption implausibly implies that the real risk-free rate and inflation is expected to systematically and continuously rise or fall.

Although expectations for short and long-term real risk-free rates and inflation should equal over time, in finite time periods, short and long-term expectations may differ. Short-term interest rates tend to be more volatile than long-term interest rates.[17] Consequently, over time U.S. Treasury bill yields are less biased (i.e., more accurate) but less reliable (i.e., more volatile) estimators of the long-term risk-free rate than U.S. Treasury bond yields. In comparison, U.S. Treasury bond yields are more biased (i.e., less accurate) but more reliable (i.e., less volatile) estimators of the long-term risk-free rate. Therefore, an estimator of the long-term nominal risk-free rate should not be chosen mechanistically. Rather, the similarity in current short and long-term nominal risk-free rates should be evaluated. If those risk-free rates are similar, then U.S. Treasury bill yields should be used to measure the long-term nominal risk-free rate. If not, some other proxy or combination of proxies should be used.

Q. What are the current yields on three-month U.S. Treasury bills and thirty-year U.S. Treasury bonds?

A. Three-month U.S. Treasury bills are currently yielding 3.36%. Thirty-year U.S. Treasury bonds are currently yielding 5.60%. Both estimates are derived from quotes for August 10, 2001.[18] Schedule 5.7 presents the published quotes and effective yields.

Q. Of the U.S. Treasury bill and bond yields, which is currently a better proxy for the long-term risk-free rate?

A. In terms of the gross domestic product ("GDP") price index, WEFA forecasts the inflation rate will average 1.8% annually during the 2001-2020 period.[19] In terms of the consumer price index ("CPI"), the *Survey of Professional Forecasters* ("Survey") forecasts the inflation rate will average 2.6% during the next ten years.[20] In terms of real GDP growth, WEFA forecasts the real risk-free rate will average 3.1% during the 2001-2020 period.[21] The Survey forecasts real GDP growth will average 3.3% during the next ten years.[22, 23] Those forecasts imply a long-term,

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[17] Fabozzi and Pollack, ed., *The Handbook of Fixed Income Securities*, Fourth Edition, Irwin, p. 789.

[18] The Federal Reserve Board, *Federal Reserve Statistical Release: Selected Interest Rates, H.15 Daily Update*, http://www.federalreserve.gov/releases/H15/update/, August 13, 2001.

[19] *U.S. Long-Term Economic Outlook*, vol. 1, WEFA Group, First Quarter 2001, pp. 4.4-4.5.

[20] *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, www.phil.frb.org/files/spf/survq101.html, May 21, 2001. The *Survey* aggregates the forecasts of approximately thirty forecasters.

[21] *U.S. Long-Term Economic Outlook*, vol. 1, WEFA Group, First Quarter 2001, pp. 4.2-4.3.

[22] *Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, www.phil.frb.org/files/spf/survq101.html, February 20, 2001.

[23] Historically, the realized interest rate return premium averaged 1.4% during the last 75 years (Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation, 2001 Yearbook*, p. 174).

nominal risk-free rate between 5.0% and 6.0%.[24] Therefore, WEFA and Survey forecasts of inflation and real GDP growth expectations indicate that the U.S. Treasury bond yield more closely approximates the long-term risk-free rate at this time. It should be noted, however, that the estimate from using the U.S. Treasury bond yield contains an upward bias due to the inclusion of an interest rate risk premium associated with its relatively long term to maturity.

Q. Please explain why the real risk-free rate and the GDP growth rate should be similar.

A. Risk-free securities provide a rate of return sufficient to compensate investors for the time value of money, which is a function of production opportunities, time preferences for consumption, and inflation.[25] The real risk-free rate does not include premiums for inflation; therefore, only production opportunities and consumption preferences affect it. The real GDP growth rate measures output of goods and services excluding inflation and, as such, also reflects both production and consumers' consumption preferences. Therefore, both the real GDP growth rate and the real risk-free rate of return should be similar since both are a function

[24] Nominal interest rates are calculated as follows:

$$r = (1 + R) \times (1 + i) - 1.$$

where r ≡ nominal interest rate;
R ≡ real interest rate; and
i ≡ inflation rate.

[25] Brigham and Houston, Fundamentals of Financial Management, 8th edition.

of production opportunities and consumption preferences without the effects of a risk premium or an inflation premium.

Q. How was the expected rate of return on the market portfolio estimated?

A. The expected rate of return on the market was estimated by conducting a DCF analysis on the firms composing the S&P 500 Index ("S&P 500"). That analysis used dividends and closing market prices as of June 28, 2001 as reported in the July 2001 edition of *S&P Security Owner's Stock Guide*. Growth rate estimates were obtained from the June 2001 edition of *IBES Monthly Summary Data* and July 2 and August 1, 2001 Zacks reports. Firms not paying a dividend as of June 28, 2001, or for which neither IBES nor Zacks growth rates were available were eliminated from the analysis. The resulting company-specific estimates of the expected rate of return on common equity were then weighted using market value data from Salomon Smith Barney, *Performance and Weights of the S&P 500: Second Quarter 2001*. The estimated weighted average expected rate of return for the remaining 365 firms, composing 78.31% of the market capitalization of the S&P 500, equals 15.31%.

Q. How did you measure market risk on a security-specific basis?

A. Beta measures risk in a portfolio context. When multiplied by the market risk premium, a security's beta produces a market risk premium specific to that

security. I used Value Line's beta estimates for the companies in my samples. The Value Line beta for a security is estimated with the following model using an ordinary least-squares technique:[26]

$$R_{j,t} = a_j + \beta_j \times R_{m,t} + e_{j,t}$$

where $R_{j,t}$ ≡ the return on security j in period t;
$R_{m,t}$ ≡ the return on the market portfolio in period t;
a_j ≡ the intercept term for security j;
β_j ≡ beta, the measure of market risk for security j; and
$e_{j,t}$ ≡ the residual term in period t for security j.

A beta can be calculated for firms with market-traded common stock. Value Line calculates its betas in two steps. First, the returns of each company are regressed against the returns of the New York Stock Exchange Composite Index to estimate a raw beta. The regression analysis employs 260 weekly observations of stock return data. Then, an adjusted beta is estimated through the following equation:

$$\beta_{adjusted} = 0.35 + 0.67 \times \beta_{raw}.$$

From the individual betas of the companies in each sample a single average beta was computed for each sample to be input into the CAPM.

Q. In past rate cases Staff has calculated its own estimates of beta. Why did you elect to use the Value Line adjusted beta estimates?

[26] Statman, Meir, "Betas Compared: Merrill Lynch vs. Value Line", *The Journal of Portfolio*

A. The price returns of the S&P 500, which is the market proxy in the methodology Staff traditionally uses, were uncorrelated with utility price returns over the last five years, which implies utility raw betas equal zero. This is an implausible result. Therefore, I used the Value Line adjusted beta estimates.

Q. Why do you use an adjusted beta estimate?

A. I use an adjusted beta estimate for two reasons. First, betas tend to regress towards the market mean value of 1.0 over time; therefore, the adjustment represents an attempt to estimate a forward-looking beta. Second, empirical tests of the CAPM suggest that the linear relationship between risk, as measured by raw beta, and return is flatter than the CAPM predicts. That is, securities with raw betas less than one tend to realize higher returns than the CAPM predicts. Conversely, securities with raw betas greater than one tend to realize lower returns than the CAPM predicts. Adjusting the raw beta estimate towards the market mean value of 1.0 compensates for the observed flatness in the linear relationship between risk and return.[27] Securities with betas less than one are adjusted upwards thereby increasing the predicted required rate of return towards observed realized rates of return. Conversely, securities with betas greater than one are adjusted downwards thereby decreasing the predicted required rate of return towards observed realized rates of return.

Management, Winter 1981.

[27] Litzenberger, Ramaswamy and Sosin, "On the CAPM Approach to the Estimation of A Public Utility's Cost of Equity Capital," *Journal of Finance*, May 1980, pp. 375-376.

Q. What are the beta estimates for the electric sample and the gas sample?

A. The average Value Line adjusted beta for the Electric sample equals 0.54. The average Value Line adjusted beta for the Gas sample equals 0.56.

Q. What required rate of return on common equity does the risk premium model estimate for the two samples?

A. The risk premium model estimates a required rate of return on common equity of 10.94% for the Electric sample and 11.06% for the Gas sample. The computation of those estimates appears on Schedule 5.7.

Cost of Equity Recommendation

Q. Based on your entire analysis, what is your estimate of the required rate of return on the common equity for ComEd?

A. A thorough analysis of the required rate of return on common equity requires both the application of financial models and the analyst's informed judgment. An estimate of the required rate of return on common equity based solely on judgment is inappropriate. Nevertheless, because techniques to measure the required rate of return on common equity necessarily employ proxies for investor expectations, judgment remains necessary to evaluate the results of such analyses. Along with DCF and risk premium analyses, I have considered the observable 7.00% rate of

return the market currently requires on less risky A-rated corporate long-term debt.[28] Based on my analysis, in my judgment the investor-required rate of return on common equity for ComEd equals 11.71%.

Q. Please summarize how you determined the 11.71% estimate of the investor-required rate of return on common equity for ComEd.

A. I considered the results of the DCF-derived and risk premium-derived results for the electric and gas samples. The average investor required rate of return on common equity for the Electric sample, 12.16%, is based on the average of the DCF-derived results (13.37%) and the risk premium-derived results (10.94%). The average investor required rate of return on common equity for the Gas sample, 11.48%, is based on the average of the DCF-derived results (11.90%) and the risk premium-derived results (11.06%). The models from which the individual company estimates were derived are correctly specified and thus contain no source of bias. Moreover, I am unaware of bias in my proxy for investor expectations.[29] In addition, measurement error has been minimized through the use of a sample, since estimates for a sample as a whole are subject to less measurement error than individual company estimates.

[28] *Standard & Poor's Benchmark Corporate Yields*, Bond Resources, www.bondresources.com/Corporate/Rates/AAA.

[29] Except as discussed above in regard to U.S. Treasury bond yields as proxies for the long-term risk-free rate.

Q. Why did you base your recommended return on common equity on your estimates for both samples?

A. Based on S&P Credit ratings and business positions and common equity ratios, as presented on Schedule 5.8, the Electric sample is more risky than ComEd. Therefore, the cost of equity estimates based on the companies that comprise that sample overstate the cost of equity for ComEd. The Gas sample is less risky than ComEd, based on the criteria presented on Schedule 5.8, which results in the cost of equity being slightly understated. However, the average credit rating and business profile[30] of the companies in the Gas sample better represent ComEd's electric delivery service operations. Therefore, I took a weighted average of the results for the electric and gas samples. I applied one-third weight to the electric sample average investor-required rate of return on common equity, and two-thirds weight to the gas sample average investor-required rate of return on common equity. My recommended cost of equity for ComEd, 11.71%, is the result of that calculation.

Overall Cost of Capital Recommendation

Q. What is the overall cost of capital for ComEd?

[30] S&P assigns companies business profiles ranging from 1 to 10 based on business risk, with 1 being the lowest business risk and 10 being the highest. Standard & Poor's, *Utilities & Perspectives*, June 21, 1999.

A. As shown on Schedule 5.1, ComEd's overall cost of capital is 8.74%. The recommended estimate incorporates a cost of common equity of 11.71%.

Response to Mr. Thone

Q. Please evaluate Mr. Thone's analyses of ComEd's cost of common equity.

A. The leverage adjustments that Mr. Thone made to his estimates of the cost of common equity for the electric and gas samples are seriously flawed and do not accurately reflect the effect of leverage on the cost of equity. In addition, the comparable earnings estimates that Mr. Thone provides are not appropriate proxies for the investor-required rate of return on ComEd's common equity.[31]

Leverage Adjustment

Q. Please describe the leverage adjustments that Mr. Thone made to the cost of equity estimates for his samples.

A. Mr. Thone used the Miller model to adjust his DCF estimates and the Hamada model to adjust his CAPM estimates. The Miller model is a method for measuring the effect on the cost of common equity due to changes in leverage in the capital structure based on the classic theory developed by Modigliani and Miller. The Miller model equation is as follows:

[31] ComEd Ex. 8.0, Direct Testimony of Daniel E. Thone.

573 $$k_{sL} = k_{sU} + (k_{sU} - k_D)(1 - T)(D/S)$$

Where:

k_{sL} ≡ the cost of equity for a levered firm;

k_{sU} ≡ the cost of equity for an unlevered firm;

k_D ≡ the cost of debt;

T ≡ the corporate tax rate

D ≡ the market value of debt; and

S ≡ the market value of equity.[32]

574 After he calculated initial DCF estimates for each of the companies in his samples
575 using the quarterly DCF model (that has been consistently adopted by the
576 Commission), Mr. Thone used the Miller model to calculate the equivalent return
577 for unlevered companies for his samples. He then re-levered the returns using
578 ComEd's proposed capital structure.[33]

579 The Hamada model modifies the beta component of the CAPM model to account
580 for the effect of a company's financial leverage on its risk. Similarly to his Miller
581 model adjustment, Mr. Thone removed the effect of financial leverage from his
582 sample companies' betas using market-value capital structures to obtain an
583 unlevered beta and then re-levered it using the proposed capital structure of
584 ComEd. Mr. Thone then used the re-levered betas for his sample companies
585 when estimating the cost of equity with the CAPM methodology.[34] The Hamada

[32] Brigham, Eugene F., et. al., Financial Management: Theory and Practice, pp. 622-632.
[33] ComEd Ex. 8.0, Direct Testimony of Daniel E. Thone, pp. 10-12.
[34] ibid.

model equation can be expressed as follows: the cost of equity to an unlevered firm is equal to the risk-free rate plus a business risk premium plus a financial risk premium, or:

$$k_{sL} = k_{RF} + (k_M - k_{RF})b_U + (k_M - k_{RF})b_U(1-T)(D/S)$$

Where:

k_{sL} ≡ the cost of equity for a levered firm;

k_{RF} ≡ the risk-free rate;

k_M ≡ the rate of return for the market portfolio;

b_U ≡ the unlevered beta;

T ≡ the corporate tax rate;

D ≡ market value of debt; and

S ≡ market value of equity.

Q. Please define the term financial leverage.

A. Financial leverage is the amount of fixed financial obligations in relation to equity in a firm's capital structure. The greater the proportion of fixed financial obligations, the greater the financial leverage.

Q. Do the leverage adjustments as implemented by Mr. Thone accurately reflect the effect of financial leverage on the cost of equity?

A. Mr. Thone 's leverage adjustments do not accurately reflect the effect on the cost of equity from differing degrees of financial leverage. The models that Mr. Thone

used to adjust the cost of equity estimates for his sample companies measure leverage too simplistically to accurately estimate the effect of leverage on the capital structure. Moreover, Mr. Thone implemented those models using inconsistent capital structure data in a manner that exaggerated the differences in ComEd's financial leverage in comparison to his sample companies.

The models fail to reflect the significance a company's cost of debt has on financial leverage. One of the narrow assumptions of the model is that all companies with the same capital structure have the same cost of debt and are able to borrow at the risk-free rate, which is simply not true. The higher the cost of debt, the higher the companies' interest payment obligations, and therefore the more levered the company. This relationship is illustrated in the following example, which assumes that Firm A (1) pays a 40% corporate tax rate; (2) has a capital structure consisting of 60% debt and 40% equity; (3) has a cost of debt of 6%; and (4) has an unlevered cost of equity of 10%. According to the Miller model, Firm A's levered cost of equity is 13.6%, calculated as follows:

$$k_{sL} = 10\% + (10\% - 6\%)(1-0.40)(60/40) = 13.6\%.$$

Now assume that all of the aforementioned assumptions apply to Firm B as well, with the exception of the cost of debt. Firm B's cost of debt is 8%. According to the Miller model, Firm B's levered cost of equity is 11.8%, calculated as follows:

$$k_{sL} = 10\% + (10\% - 8\%)(1-0.40)(60/40) = 11.8\%.$$

The above example illustrates that increasing the cost of debt results in a decreased cost of equity estimate. Financial theory suggests that increasing the cost of debt would increase the amount of financial leverage to which a firm is exposed. More of the firm's financial resources must be dedicated to making interest payments. Therefore, fewer funds are available to provide a return to equity investors, creating more risk to the equity investor, who will demand a higher return. The Miller model exhibits the opposite effect, which is illogical. Hence, the Miller model does not accurately reflect the effects of increasing leverage on a firm's capital structure.

Q. Did Mr. Thone implement the leverage adjustments through the Miller and Hamada models properly?

A. No. Mr. Thone used the market value capital structures of the sample companies to unlever the cost of equity estimates. When re-levering, Mr. Thone used ComEd's proposed book value capital structure. Essentially, Mr. Thone adjusted his market-based DCF and CAPM models for application to book value, which has both theoretical and empirical flaws. These adjustments are based on the incorrect notion that utilities should be authorized rates of return on common equity in excess of the investor-required return whenever their market values exceed book values, a false notion that the Commission has previously rejected.[35]

[35] Amended Order, Docket No. 97-0351, p. 42; Order, Docket No. 99-0121, p. 68.

Moreover, Mr. Thone's mix of market and book values erroneously implies that financial risk depends on the units of measure. The balance of common equity can be measured in terms of market value or book value. However, the amount of financial leverage is not altered depending on which unit of measurement is used. The intrinsic risk level of a given company does not change simply because the manner in which it is being measured has changed. Capital structure ratios are merely indicators of financial risk, they are not sources of financial risk. Financial risk arises from contractually required debt service payments. Changing capital structure ratios from a market to book value basis does not affect a company's debt service requirements. Therefore, adjustments based on mere differences in the units of measurement are inappropriate.

Q. How does the book value capital structure that you are proposing for ComEd compare to the book value capital structures of the companies in Mr. Thone's samples?

A. Using data from *S&P Utility Compustat* for the four quarters of the year 2000, I computed the average book value capital structures for the companies in Mr. Thone's samples. The average total debt to equity ratio for the companies in Mr. Thone's electric sample equals 1.64, while the average total debt to equity ratio for the companies in his gas sample equals 1.30. ComEd's total debt to equity ratio, using my proposed capital structure of 61% debt and 39% equity equals 1.54. Further, the average common equity to total capitalization equals 38.08% for the

electric sample and 43.93% for the gas sample. The average total debt to capitalization equals 60.08% for the electric sample and 55.44% for the gas sample. Based on book value, Mr. Thone's samples are not significantly different from ComEd in terms of leverage.

Q. Is it proper to use book value or market value when implementing the models to adjust for differences in leverage?

A. Market value should be used when implementing the Miller and Hamada models. Because ComEd's common stock is not market traded, its market value of common equity is unobservable. I estimated ComEd's market value of common equity using the average market to book ratios for Mr. Thone's sample companies.[36] The average 2000 market to book value for his electric sample equals 1.97, while that of his gas sample is 2.01. I then compared the debt to market equity ratios of the samples to the implied debt to market equity ratios for ComEd. For the electric sample, the debt to market equity ratio equals 0.86, and the implied debt to market equity ratio of ComEd is 0.78. For the gas sample, the debt to market equity ratio equals 0.61, and the implied debt to market equity ratio of ComEd is 0.77.

Q. What did you conclude from your comparisons of book value to book value and market value to market value?

A. I concluded that when financial leverage is compared with similar units, the difference in leverage financial and capital structure between the electric and gas samples is not nearly as great as Mr. Thone's analysis that mixes book and market values indicates. Mr. Thone's implementation of the models greatly exaggerated the difference in financial leverage between ComEd and his samples.

Q. How does Mr. Thone treat the TFNs when executing the leverage adjustments?

A. Mr. Thone included the TFNs in the capital structure of ComEd and treated them as regular debt.

Q. Is Mr. Thone's treatment of the TFNs as regular debt proper?

A. No, not according to ComEd in Docket No. 98-0319. ComEd claimed that the TFNs have terms that differentiate them from traditional long-term debt issues. ComEd argued that unlike bank debt, payments of principal on the TFNs may be deferred and that the TFNs do not encumber any physical assets of ComEd, unlike mortgage bonds.[37] ComEd asserted that the issuance of the TFNs and the use of the proceeds would reduce the riskiness of ComEd's equity and reduce its overall

[36] ComEd Response to Staff Data Request FIN-6, Schedule WPFIN-6.1.
[37] Docket No. 98-0319, ComEd Ex. 8.0, Rebuttal Testimony of William A. Abrams, p. 5.

694 cost of capital. ComEd claimed that the TFNs would be less of a burden than
695 debt.[38]

696 ComEd also argued that cost of capital models, such as the Miller and Hamada
697 models, do not lead to meaningful estimates of the impact of the transitional
698 financing on the long-term cost of capital.[39] Thus, ComEd's arguments in Docket
699 No. 98-0319 indicate that treating TFNs like regular debt causes the models to
700 overstate the effect of financial leverage from TFNs on the cost of equity.

701 **Q. Has the Commission ever rejected use of the Miller model or the Hamada**
702 **model to adjust a utility's cost of equity for the effects of financial**
703 **leverage?**

704 A. Yes. In Docket No. 99-0120/99-0134 Consol., the Commission concluded "that
705 while the Hamada model may be useful for measuring the relative cost of capital
706 over a range of capital structures, it may not be appropriate for estimating a
707 specific cost of capital for ratemaking purposes."

708 In Docket 98-0319, ComEd's securitization case, and Docket 98-0448, Illinois
709 Power Company's ("IP") securitization case, the Miller model and the Hamada
710 equation were used to measure the relative cost of capital over a range of capital
711 structures. The use of those models has only been approved by the Commission
712 to examine the effects on equity return when capital structure changes occur.

[38] Order, Docket No. 98-0319, July 21, 1998, p. 22.

These leverage adjustments are not suitable for estimating a particular cost of equity.

Comparable Earnings

Q. Please describe Mr. Thone's comparable earnings analysis of the cost of equity for ComEd.

A. Mr. Thone used *Value Line* estimates of return on equity for the years 2003 through 2005 for the companies in his samples to estimate ComEd's cost of equity. He claims that investors use future estimates provided by *Value Line* in setting their return expectations.

Q. Is it appropriate to rely on Value Line return on equity estimates to determine the investor required return on equity for ComEd?

A. No. The expected returns on book value are not appropriate estimates for required returns. The cost of common equity is the market-required rate demanded by investors. In contrast, comparable earnings analysis is not a market-based methodology. The comparable earnings method incorrectly implies that the rate of return on book common equity is equivalent to current investor-required rates of return. There is simply no basis for that implication since the accounting return that the comparable earnings method measures may be more or

[39] Docket 98-0319, ComEd Ex. 7.0, Rebuttal Testimony of Willard T. Carleton, p. 4

less than the return investors require for an investment. For example, if the expected return on a company's market equity is 20% while the investor required rate or return is only 10%, investors will bid up the price in the marketplace until the expected return on market equity equals the required 10% return. The market price of a common stock does not achieve equilibrium until the expected rate of return on the common stock equals the investor-required rate of return. In contrast, the return on book value has no such adjustment mechanism since the denominator, book value, is immune to market forces.

Q. Has the Commission rejected use of the comparable earnings analysis to measure a utility's cost of equity?

A. Yes. The Commission rejected use of the comparable earnings methodology in Docket Nos. 99-0121, 89-0033, and 92-0448/93-0239 Consol.[40]

Response to Dr. Peltzman and Dr. Culp

Q. Please summarize the testimonies of Dr. Peltzman and Dr. Culp regarding the risk of electric utilities?

A. Dr. Peltzman and Dr. Culp claim that the electric utility industry in Illinois is becoming more risky due to the reduction in regulation from the restructuring of

[40] Order, Docket 99-0121, August 25, 1999, p. 68; Order on Remand, Docket No. 89-0033, November 4, 1991, p.15; Order, Docket No. 92-0448/93-0239 Consol., October 11, 1994, p. 173.

electricity. They claim that restructuring creates risks from price arbitrage and classic externalities and will increase the impact of demand fluctuations on the variability of ComEd's cash flow.[41] Dr. Peltzman testified that the risks from increased price volatility that ComEd will bear in the future will be priced into ComEd's equity today. One of the risks of the power supply business concerns the ability of suppliers to eliminate price risks arising from differences in the price paid to purchase power from generators and the price at which that power can be sold to customers. Dr. Culp testified that as provider of last resort, ComEd's investors will require compensation for bearing additional risks in excess of that estimated via pure systematic risk-based cost of capital methods.

Q. Do you agree with Dr. Pelzman and Dr. Culp's assessment of the risk posed to ComEd due to the restructuring of electricity markets in Illinois?

A. No. The restructuring of the industry has eliminated the risks associated with owning and operating generation that was previously borne by integrated electric utilities. The transmission and distribution business that ComEd retained is certainly not risk-free, but neither is it as risky as the generation assets ComEd shed.

In October of 2000, Standard & Poor's ("S&P") raised ComEd's corporate credit rating from BBB+ to A- and assigned its A- corporate credit rating and stable

[41] ComEd Ex. 9.0, Direct Testimony of Prof. Sam Peltzman; ComEd Ex. 10.0, Direct Testimony of Christopher Lee Culp, Ph.D.

outlook to Exelon. Simultaneously, ComEd's business position rating went up from 7 to 4.[42] S&P reported that:

> Exelon's business profile is a function of the operating risks posed by substantial nuclear asset exposure and a growing emphasis on wholesale power marketing. These features are tempered substantially by supportive restructuring legislation and commission orders in Illinois and Pennsylvania, as well as low-risk electric and gas transmission and distribution operations.[43]

The ratings assigned by S&P reflect ComEd's above average business profile and solid financial measures. A 2001 summary report from S&P stated:

> ComEd's business profile is supported by its low-risk electric transmission and distribution assets, supportive restructuring legislation and commission orders, the transfer of its nuclear assets to Exelon, the sale of its fossil generating assets to Edison Mission Energy, and a rebounding service territory with a below-average proportion of industrial sales. ComEd benefited significantly from legislation governing competition in the state. ComEd's financial strength is derived from the securitization financing, healthy internal cash generation, and continued cost control efforts."[44]

The S&P reports contradict ComEd's claims that, due to restructuring, the risk of ComEd's transmission and distribution business is so great that the cost of equity capital is beyond that which can be established using traditional cost of equity models.

Q. Does this conclude your direct testimony?

A. Yes.

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[42] The business position ratings assess the qualitative attributes of a firm, with "1" being considered lowest risk and "10" highest risk.

[43] S&P Utilities and Perspectives, 10/23/00, p.6.

[44] Standard & Poor's Ratings Direct, Summary: Commonwealth Edison Co., 8/6/01.

Docket No. 01-0423
ICC Staff Exhibit 5.0
Schedule 5.1

Commonwealth Edison Company

Weighted Average Cost of Capital

Company Proposal

Pro-forma December 31, 2000

Component	Balance	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	$6,963,798,000 [1]	53.99%	7.14%	3.86%
Common Equity	$5,933,786,000 [2]	46.01%	13.25%	6.10%
Total Capital	$12,897,584,000	100.00%		
Weighted Average Cost of Capital				**9.95%**

[1] Pro-forma adjustments through December 31, 2002
[2] Pro-forma adjustments through January 2001

Staff Proposal

March 31, 2001

Component	Balance	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	$7,629,187,696	60.64%	6.82%	4.13%
Common Equity	$4,952,000,000	39.36%	11.71%	4.61%
Total Capital	$12,581,187,696	100.00%		
Weighted Average Cost of Capital				**8.74%**

Commonwealth Edison Company

Embedded Cost of Long-Term Debt
March 31, 2001

Description	Coupon Rate	Date Issued	Maturity Date	Face Amount Outstanding	Unamortized Discount or Premium	Unamortized Debt Expense	Carrying Value	Annualized Coupon Interest	Annualized Amortization of Discount or Premium	Annualized Amortization of Debt Expense	Annualized Debt Expense
First Mortgage Bonds											
Series 85	7.375%	09/15/92	09/15/02	$200,000,000	($181,594)	$12,231	$200,169,363	$14,750,000	($124,356)	$8,376	$14,634,020
Series 96	6.625%	07/15/93	07/15/03	$100,000,000	$280,643	$18,350	$99,701,007	$6,625,000	$122,530	$8,012	$6,755,541
Pollution Control-1994A	5.300%	01/15/94	01/15/04	$26,000,000	$40,241	$29,162	$25,930,597	$1,378,000	$14,400	$10,435	$1,402,835
Series 93	7.000%	07/01/93	07/01/05	$225,000,000	$911,538	$52,963	$224,035,499	$15,750,000	$214,238	$12,448	$15,976,686
Series 76	8.250%	10/01/91	10/01/06	$100,000,000	($1,526,846)	$43,959	$101,482,887	$8,250,000	($277,263)	$7,983	$7,980,719
Series 78	8.375%	10/15/91	10/15/06	$125,000,000	($2,198,910)	$51,569	$127,147,342	$10,468,750	($396,543)	$9,300	$10,081,507
Pollution Control-1996A	4.400%	06/27/96	12/01/06	$110,000,000	$1,465	$1,335,748	$108,662,787	$4,840,000	$258	$235,417	$5,075,675
Pollution Control-1996B	4.400%	06/27/96	12/01/06	$89,400,000	$1,190	$1,090,483	$88,308,326	$3,933,600	$210	$192,190	$4,126,000
Series 83	8.000%	05/15/92	05/15/08	$140,000,000	($1,741,318)	$77,890	$141,663,428	$11,200,000	($244,266)	$10,926	$10,966,660
Pollution Control-1994B	5.700%	01/15/94	01/15/09	$20,000,000	$374,206	$39,616	$19,586,178	$1,140,000	$47,975	$5,079	$1,193,054
Pollution Control-1991	7.250%	06/01/91	06/01/11	$100,000,000	($840,152)	$171,728	$100,668,423	$7,250,000	($82,567)	$16,877	$7,184,309
Series 92	7.625%	04/15/93	04/15/13	$220,000,000	$2,027,568	$156,191	$217,816,240	$16,775,000	$168,272	$12,963	$16,956,235
Series 94	7.500%	07/01/93	07/01/13	$150,000,000	$2,401,298	$67,621	$147,531,082	$11,250,000	$195,860	$5,515	$11,451,375
Pollution Control-1994C	5.850%	01/15/94	01/15/14	$20,000,000	$1,083,597	$48,771	$18,867,633	$1,170,000	$84,638	$3,809	$1,258,447
Pollution Control-1994D	6.750%	12/01/94	03/01/15	$91,000,000	$1,475,597	$1,708,912	$87,815,491	$6,142,500	$105,960	$122,714	$6,371,173
Series 75	9.875%	06/15/90	06/15/20	$260,000,000	($14,865,328)	$349,234	$274,516,094	$25,675,000	($773,353)	$18,169	$24,919,815
Series 81	8.625%	02/01/92	02/01/22	$200,000,000	($323,411)	$302,402	$200,021,010	$17,250,000	($15,508)	$14,500	$17,248,993
Series 84	8.500%	07/15/92	07/15/22	$200,000,000	$759,736	$360,012	$198,880,252	$17,000,000	$35,661	$16,899	$17,052,560
Series 86	8.375%	09/15/92	09/15/22	$200,000,000	$2,149,137	$190,094	$197,660,769	$16,750,000	$100,081	$8,852	$16,858,933
Series 88	8.375%	02/15/93	02/15/23	$235,950,000	$2,430,098	$196,309	$233,323,593	$19,760,813	$110,998	$8,967	$19,880,777
Series 91	8.000%	04/15/93	04/15/23	$160,000,000	$4,871,608	$117,434	$155,010,957	$12,800,000	$220,887	$5,325	$13,026,211
Series 97	7.750%	07/15/93	07/15/23	$150,000,000	$7,019,887	$79,888	$142,900,226	$11,625,000	$314,735	$3,582	$11,943,317
Total First Mortgage Bonds				$3,122,350,000	$4,150,247	$6,500,567	$3,111,699,185	$241,783,663	($177,154)	$738,336	$242,344,845
Sinking Fund Debentures											
2.875%	2.875%	10/01/50	04/01/01	1,000,000.00	$1	$12	$999,987	$28,750	$422	$4,369	$33,541
3.125%	3.125%	10/01/54	10/01/04	4,925,000.00	$50,118	$12,677	$4,862,205	$153,906	$14,291	$3,615	$171,813
3.875%	3.875%	01/01/58	01/01/08	8,000,000.00	$224,366	$22,394	$7,753,240	$310,000	$33,196	$3,313	$346,509
4.625%	4.625%	01/01/59	01/01/09	3,568,000.00	$103,736	$13,094	$3,451,169	$165,020	$13,365	$1,687	$180,072
4.750%	4.750%	12/01/61	12/01/11	9,181,000.00	($460,232)	$30,535	$9,610,697	$436,098	$0	$2,860	$438,957
Publishing Fee's Annual Notice										$28,942	$28,942
Publishing Fee's Annual Notice										$14,470	$14,470
Total Sinking Fund Debentures				$26,674,000	($82,011)	$78,713	$26,677,297	$1,093,774	$61,274	$59,256	$1,214,304
Sub. Deferrable Interest Notes											
Sub. Deferrable Interest Notes	8.480%	09/26/95	09/30/35	$206,190,000		$5,920,163	$200,269,837	$17,484,912		$171,483	$17,656,395
Sub.Def. Interest Debentures	8.500%	01/24/97	01/15/27	$154,640,000		$1,678,019	$152,961,981	$13,144,400		$65,012	$13,209,412
Total Sub. Def. Interest Notes				$360,830,000		$7,598,182	$353,231,818	$30,629,312		$236,495	$30,865,807

Description	Coupon Rate	Date Issued	Maturity Date	Face Amount Outstanding	Unamortized Discount or Premium	Unamortized Debt Expense	Carrying Value	Annualized Coupon Interest	Annualized Amortization of Discount or Premium	Annualized Amortization of Debt Expense	Annualized Debt Expense
Transitional Funding Notes											
Class A-2 Int. Trans. Prop. Notes	5.290%	12/16/98	06/25/01	$143,748,642		$68,206	$143,680,436	$7,604,303		$289,478	$7,893,781
Class A-3 Int. Trans. Prop. Notes	5.340%	12/16/98	03/25/02	$258,860,915		$133,790	$258,727,125	$13,823,173		$136,026	$13,959,199
Class A-4 Int. Trans. Prop. Notes	5.390%	12/16/98	06/25/03	$421,139,085		$357,880	$420,781,205	$22,699,397		$160,081	$22,859,478
Class A-5 Int. Trans. Prop. Notes	5.440%	12/16/98	03/25/05	$598,510,714		$653,945	$597,856,769	$32,558,983		$164,048	$32,723,031
Class A-6 Int. Trans. Prop. Notes	5.630%	12/16/98	06/25/07	$761,489,286		$958,251	$760,531,035	$42,871,847		$153,606	$43,025,453
Class A-7 Int. Trans. Prop. Notes	5.740%	12/16/98	12/25/08	$510,000,000		$677,105	$509,322,895	$29,274,000		$87,453	$29,361,453
Total Transitional Funding Notes				$2,693,748,642		$2,849,178	$2,690,899,464	$148,831,702		$990,694	$149,822,396
Pollution Control Obligations											
IL Ind. Poll. Control Fin. Auth.	5.875%	05/15/77	05/15/07	$45,500,000	$189,475.54	$65,848.64	$45,244,676	$2,673,125	$30,930	$10,749	$2,714,804
IL Dev. Fin. Auth. Series 1994B	variable	12/14/94	03/01/09	$42,200,000	$499.73	$174,707.78	$42,024,792	$1,084,540	$27	$22,050	$1,106,617
IL Dev. Fin. Auth. Series 1994C	variable	10/05/94	10/15/14	$50,000,000	$363.77	$145,624.71	$49,854,012	$1,285,000	$63	$10,747	$1,295,810
Total Pollution Control Obligations				$137,700,000	$190,339	$386,181	$137,123,480	$5,042,665	$31,020	$43,546	$5,117,230
Purchase Contract Obligations											
Village of Hinsdale	3.000%	04/30/55	04/30/05	$254,174			$254,174	$7,625			$7,625
Total Purchase Contract Obls.				$254,174			$254,174	$7,625			$7,625
Medium Term Notes											
3N- 3037	9.170%	10/20/89	10/15/02	$25,000,000	($110,252)	$7,068	$25,103,184	$2,292,500	($71,478)	$4,582	$2,225,605
3N- 3038	9.170%	10/20/89	10/15/02	$2,000,000	($8,820)	$565	$2,008,255	$183,400	($5,718)	$367	$178,048
3N- 3039	9.170%	10/20/89	10/15/02	$25,000,000	($110,252)	$7,068	$25,103,184	$2,292,500	($71,478)	$4,582	$2,225,605
3N- 3040	9.170%	10/20/89	10/15/02	$23,000,000	($101,432)	$6,502	$23,094,929	$2,109,100	($65,759)	$4,216	$2,047,556
3N- 3041	9.170%	10/20/89	10/15/02	$25,000,000	($110,252)	$7,068	$25,103,184	$2,292,500	($71,478)	$4,582	$2,225,605
3N- 3032	9.200%	10/18/89	10/15/04	$14,000,000	($207,888)	$7,880	$14,200,009	$1,288,000	($58,639)	$2,223	$1,231,583
3N- 3033	9.200%	10/18/89	10/15/04	$14,000,000	($207,888)	$7,880	$14,200,009	$1,288,000	($58,639)	$2,223	$1,231,583
3N- 3034	9.200%	10/18/89	10/15/04	$10,000,000	($148,491)	$5,628	$10,142,863	$920,000	($41,885)	$1,588	$879,703
3N- 3035	9.200%	10/18/89	10/15/04	$14,000,000	($20,789)	$7,879	$14,012,909	$1,288,000	($5,864)	$2,223	$1,284,359
3N- 3036	9.200%	10/18/89	10/15/04	$4,000,000	($60,105)	$2,251	$4,057,854	$368,000	($16,954)	$635	$351,681
Senior Note	Variable	09/14/00	09/30/02	$200,000,000	($363,608)		$200,363,608	$8,177,500	($242,184)		$7,935,316
Senior Note	Variable	09/14/00	09/30/03	$250,000,000	($900,356)		$250,900,356	$10,534,375	($359,945)		$10,174,430
Total Medium Term Notes				$606,000,000	($2,350,131)	$59,789	$608,290,342	$33,033,875	($1,070,021)	$27,219	$31,991,073
Notes											
Notes	6.400%	10/15/93	10/15/05	$235,000,000	$3,903,483.92	$229,423	$230,867,093	$15,040,000	$858,814	$50,476	$15,949,289
Notes	7.375%	01/09/97	01/15/04	$150,000,000	($95,026.02)	$65,763	$150,029,263	$11,062,500	($34,004)	$23,533	$11,052,029
Notes	7.625%	01/09/97	01/15/07	$150,000,000	($277,171.13)	$94,394	$150,182,777	$11,437,500	($47,811)	$16,283	$11,405,972
Notes	6.950%	07/16/98	07/15/18	$225,000,000	$20,826,118.67	$41,374	$204,132,507	$15,637,500	$1,203,727	$2,391	$16,843,618
Total Notes				$760,000,000	$24,357,405	$430,955	$735,211,640	$53,177,500	$1,980,725	$92,683	$55,250,908
TOTAL				$7,707,556,816	$26,265,850	$17,903,566	**$7,663,387,400**	$513,600,116	$825,844	$2,188,229	**$516,614,189**

Reacquired Debt		Unamortized Loss or Gain on Reacquired Debt	Carrying Value	Annualized Amortization of Loss or Gain on Reacquired Debt	Annualized Debt Expense
First Mortgage Bonds					
Series 46	14.250%	$507,678	-$507,678	$23,151	$23,151
Series 47	15.375%	$1,473,988	-$1,473,988	$67,217	$67,217
Series 48	13.000%	$3,107,137	-$3,107,137	$256,992	$256,992
Series 44	17.500%	$136,525	-$136,525	$6,226	$6,226
Series 50	12.250%	$249,745	-$249,745	$11,389	$11,389
Series 51	13.375%	$629,098	-$629,098	$28,688	$28,688
Series 49	12.125%	$832,303	-$832,303	$433,593	$433,593
Series 55	11.750%	$1,671,529	-$1,671,529	$190,733	$190,733
Series 40	11.125%	$689,406	-$689,406	$96,117	$96,117
Series 66	12.000%	$2,579,620	-$2,579,620	$117,636	$117,636
Series 71	11.125%	$3,065,108	-$3,065,108	$139,776	$139,776
Series 33	9.375%	$0	$0	$0	$0
Series 56	10.500%	$3,063,575	-$3,063,575	$138,649	$138,649
Series 68	9.375%	$0	$0	$0	$0
Series 67	10.250%	$3,731,187	-$3,731,187	$308,607	$308,607
Series 30	8.750%	$769,511	-$769,511	$132,584	$132,584
Series 38	9.125%	$2,128,773	-$2,128,773	$366,781	$366,781
Series 23	8.000%	$0	$0	$0	$0
Series 60	9.625%	$2,908,245	-$2,908,245	$130,135	$130,135
Pollution Control 1985	10.375%	$324,235	-$324,235	$40,502	$40,502
Pollution Control 1985	10.625%	$1,633,492	-$1,633,492	$133,123	$133,123
Pollution Control 1974A	6.625%	$71,244	-$71,244	$12,562	$12,562
Series 57	9.500%	$1,919,606	-$1,919,606	$510,931	$510,931
		$31,492,004	-$31,492,004	$3,145,391	$3,145,391
Sinking Fund Debentures					
Series 7	15.375%	$0	$0	$0	$0
Series 4	10.000%	$570,673	-$570,673	$27,368	$27,368
		$570,673	-$570,673	$27,368	$27,368

Reacquired Debt			Unamortized Loss or Gain on Reacquired Debt		Carrying Value	Annualized Amortization of Loss or Gain on Reacquired Debt		Annualized Debt Expense
Pollution Control Obligations								
Joliet Series 1981	11.750%		$262,929		-$262,929	$25,854		$25,854
Pekin Series	11.750%		$267,140		-$267,140	$26,268		$26,268
Waukegan Series 1981	11.500%		$84,705		-$84,705	$8,329		$8,329
IEFFA Series 1980	10.125%		$104,485		-$104,485	$10,274		$10,274
IEFFA Series 1980	10.375%		$197,901		-$197,901	$19,460		$19,460
IEFFA Series 1979	8.375%		$35,331		-$35,331	$7,188		$7,188
IEFFA Series 1979	8.500%		$145,817		-$145,817	$29,666		$29,666
IEFFA Series 1983	9.750%		$130,174		-$130,174	$26,484		$26,484
IEFFA Series 1984	11.375%		$413,506		-$413,506	$30,417		$30,417
Pekin Series 1979	6.750%		$22,742		-$22,742	$4,010		$4,010
Waukegan Series 1979	6.750%		$17,856		-$17,856	$3,148		$3,148
Pekin Series B	6.750%		$69,608		-$69,608	$12,274		$12,274
Pekin & Joliet Series 1976	6.800%		$121,301		-$121,301	$21,389		$21,389
Waukegan Series B	6.875%		$41,438		-$41,438	$7,307		$7,307
Joliet Series B	6.875%		$170,995		-$170,995	$30,151		$30,151
Pekin Series 1979	6.875%		$27,657		-$27,657	$4,877		$4,877
Joliet Series 1979	6.875%		$23,445		-$23,445	$4,134		$4,134
			$2,137,027		-$2,137,027	$271,229		$271,229
			$34,199,704		-$34,199,704	$3,443,988		$3,443,988
		$7,707,556,816	$60,465,554	$17,903,566	**$7,629,187,696**	$513,600,116	$4,269,832	$2,188,229	**$520,058,177**
Embedded Cost of Long-Term Debt								**6.82%**

Docket No. 01-0423
ICC Staff Exhibit 5.0
Schedule 5.3

Commonwealth Edison Company

Growth Rate Estimates

Electric Sample

Company	Zacks Earnings	IBES Earnings	Average
American Electric Power	6.70%	6.19%	6.45%
CLECO Corp.	10.00%	10.03%	10.02%
DPL Inc.	10.25%	9.54%	9.90%
DQE Inc.	5.25%	5.67%	5.46%
Kansas City Power and Light	6.00%	5.67%	5.84%
NSTAR	6.60%	6.80%	6.70%
Puget Energy	5.33%	5.50%	5.42%

Gas Sample

Company	Zacks Earnings	IBES Earnings	Average
AGL Resources Inc.	6.59%	6.79%	6.69%
Atmos Energy Corp.	7.33%	7.83%	7.58%
Cascade Natural Gas Corp.	5.30%	5.00%	5.15%
NUI Corp	9.67%	10.95%	10.31%
Northwest Natural Gas Co.	5.75%	4.25%	5.00%
Peoples Energy Corp.	6.50%	5.43%	5.97%
Piedmont Natural Gas Co.	6.75%	5.33%	6.04%
South Jersey Industries	5.15%	6.00%	5.58%

Sources: *Zacks Investment Research*, http://my.zacks.com, August 6,2001.
Institutional Brokers Estimate System, June 14, 2001.

Commonwealth Edison Company

Prices and Dividends

Electric Sample

Company	Current Dividend $D_{0,1}$	$D_{0,2}$	$D_{0,3}$	$D_{0,4}$	Next Dividend Payment Date	Stock Price
American Electric Power	$ 0.600	$ 0.600	$ 0.600	$ 0.600	12/10/2001	$ 45.2400
CLECO Corp.	0.213	0.213	0.218	0.220	11/15/2001	21.9900
DPL Inc.	0.235	0.235	0.235	0.235	9/1/2001	25.6400
DQE Inc.	0.400	0.420	0.420	0.420	10/1/2001	22.5700
Kansas City Power and Light	0.415	0.415	0.415	0.415	9/20/2001	25.0000
NSTAR	0.500	0.515	0.515	0.515	11/1/2001	43.0100
Puget Energy	0.460	0.460	0.460	0.460	11/15/2001	24.1300

Gas Sample

Company	Current Dividend $D_{0,1}$	$D_{0,2}$	$D_{0,3}$	$D_{0,4}$	Next Dividend Payment Date	Stock Price
AGL Resources Inc.	$ 0.270	$ 0.270	$ 0.270	$ 0.270	9/1/2001	$ 24.4200
Atmos Energy Corp.	0.285	0.290	0.290	0.290	9/10/2001	21.2600
Cascade Natural Gas Corp.	0.240	0.240	0.240	0.240	11/15/2001	20.3600
NUI Corp	0.245	0.245	0.245	0.245	9/15/2001	22.9700
Northwest Natural Gas Co.	0.310	0.310	0.310	0.310	11/15/2001	24.7400
Peoples Energy Corp.	0.500	0.510	0.510	0.510	10/15/2001	37.7000
Piedmont Natural Gas Co.	0.365	0.365	0.385	0.385	10/15/2001	33.0000
South Jersey Industries	0.365	0.365	0.370	0.370	10/2/2001	31.3100

Sources: *The Wall Street Journal*, August 13, 2001.
Standard & Poor's, *Utility Compustat.*
http://biz.yahoo.com/prnews

Commonwealth Edison Company

Expected Quarterly Dividends

Electric Sample

Company	$D_{1,1}$	$D_{1,2}$	$D_{1,3}$	$D_{1,4}$
American Electric Power	0.639	0.639	0.639	0.639
CLECO Corp.	0.220	0.220	0.239	0.242
DPL Inc.	0.235	0.258	0.258	0.258
DQE Inc.	0.420	0.443	0.443	0.443
Kansas City Power and Light	0.415	0.439	0.439	0.439
NSTAR	0.515	0.550	0.550	0.550
Puget Energy	0.485	0.485	0.485	0.485

Gas Sample

Company	$D_{1,1}$	$D_{1,2}$	$D_{1,3}$	$D_{1,4}$
AGL Resources Inc.	$ 0.270	$ 0.288	$ 0.288	$ 0.288
Atmos Energy Corp.	0.290	0.312	0.312	0.312
Cascade Natural Gas Corp.	0.252	0.252	0.252	0.252
NUI Corp	0.270	0.270	0.270	0.270
Northwest Natural Gas Co.	0.326	0.326	0.326	0.326
Peoples Energy Corp.	0.510	0.540	0.540	0.540
Piedmont Natural Gas Co.	0.385	0.385	0.408	0.408
South Jersey Industries	0.370	0.370	0.391	0.391

Sources: Staff Schedules 5.3 and 5.4.

Commonwealth Edison Company

DCF Cost of Common Equity Estimates

Electric Sample

Company	Estimate
American Electric Power	12.29%
CLECO Corp.	14.41%
DPL Inc.	14.14%
DQE Inc.	13.70%
Kansas City Power and Light	13.22%
NSTAR	11.96%
Puget Energy	13.84%
Average	13.37%

Gas Sample

Company	Estimate
AGL Resources Inc.	11.63%
Atmos Energy Corp.	13.76%
Cascade Natural Gas Corp.	10.29%
NUI Corp	15.39%
Northwest Natural Gas Co.	10.46%
Peoples Energy Corp.	11.91%
Piedmont Natural Gas Co.	11.08%
South Jersey Industries	10.67%
Average	11.90%

Commonwealth Edison Company

Risk Premium Analysis

Interest Rates as of August 10, 2001

U.S. Treasury Bills[1]		U.S. Treasury Bonds[2]	
Discount Rate	Effective Yield	Bond Equivalent Yield	Effective Yield
3.36%	3.48%	5.52%	5.60%

Risk Premium Cost of Equity Estimates

Proxy Group	Risk-Free Rate		Beta		Risk Premium		Cost of Common Equity
Electric Sample	5.60%	+	0.55	×	(15.31% – 5.60%)	=	10.94%
Gas Sample	5.60%	+	056	×	(15.31% – 5.60%)	=	11.06%

[1] U.S. Treasury bill yields are quoted on a 360-day *discount* basis. The effective yield is determined as follows:

$$Effective\ yield = \left(1 + \frac{discount\ rate \times \left(\frac{days\ to\ maturity}{360} \right)}{1 - discount\ rate \times \left(\frac{days\ to\ maturity}{360} \right)} \right)^{\left(\frac{365}{days\ to\ maturity} \right)} - 1$$

where *days to maturity* equals ninety-one days.

[2] The bond equivalent yield on U.S. Treasury bonds represents a nominal rather than an effective yield. The effective yield is calculated as follows:

$$Effective\ yield = [1 + (bond\ equivalent\ yield \div 2)]^2 - 1.$$

Commonwealth Edison Company

Risk Comparison

Electric Sample

Company	S&P Rating	S&P Business Position	Common Equity Ratio[2]
American Electric Power	A-	4	34.35%
CLECO Corp.	BBB+	6	37.11%
DPL Inc.	BBB+	6	25.83%
DQE Inc.	BBB+	6	32.98%
Kansas City Power and Light	A-	6	38.03%
NSTAR	A	3	33.31%
Puget Energy	BBB+	4	35.32%
Average	A-/BBB+	5	33.85%

Gas Sample

Company	S&P Rating	S&P Business Position	Common Equity Ratio[2]
AGL Resources Inc.	A-	3	37.66%
Atmos Energy Corp.	A-	4	47.46%
Cascade Natural Gas Corp.	BBB+	3	47.77%
NUI Corp	A	3	40.62%
Northwest Natural Gas Co.	BBB	3	48.13%
Peoples Energy Corp.	A+	4	43.18%
Piedmont Natural Gas Co.	A	3	50.52%
South Jersey Industries[1]	BBB+	3	36.97%
Average	A-	3.25	44.04%
Commonwealth Edison Company	A-	4	39.36%

[1] S&P rating is for primary subsidiary South Jersey Gas Company.

[2] S&P *Utility Compustat*, Average Common Equity ratios for the Four Quarters Ending with the First Quarter of 2001.

Attachment A
Redacted

ICC Docket No. 01-0423
Response of Commonwealth Edison Company
To Staff's Data Requests JF-1.01 through JF-1.27
To Commonwealth Edison Company
Dated June 27, 2001

JF-1.20 Please provide the following forecasted financial statements for the years 2001 and 2002:

a) Income Statement;
b) Balance Sheet;
c) Statement of Cash Flows; and
d) Statement of Retained Earnings.

Further provide the underlying assumptions supporting the financial forecast. If the financial forecast shows any new issuances of debt, provide the assumptions with regard to the terms of the new debt (i.e., the amount, interest rate, date of issue, and term to maturity).

RESPONSE: (Confidential & Proprietary – 2nd level of Protective Order)

CONFIDENTIAL